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DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

*United Kingdom: Balance of Payments Developments
Since the Smithsonian Agreement*

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July 1973

**United Kingdom:
Balance-of-Payments Developments
Since the Smithsonian Agreement**

Improvement in Britain's payments balance in 1973 will tend to make London more receptive to joining the joint EC float. The adverse balance of trade, however, forecloses any early re-pegging of sterling. Britain's stated conditions for joining the EC float -- especially its demand that the other EC countries assume responsibility for the overseas sterling balances -- remain unacceptable to the other EC countries. Improved trade performance by the end of the year and a sharp reduction in the official settlements deficit for 1973 will increase the likelihood of an accommodation between Britain and the other EC countries. Moreover, a more favorable trade balance will bolster London's traditionally liberal stance on trade and -- by favoring sterling's inclusion in the joint float -- increase the probability of Britain's participating constructively in multilateral trade negotiations.

When the British do re-peg, it will probably be not far from the present rate, which gives sterling a trade-weighted depreciation of 13% from the exchange rates established in the Smithsonian Agreement. Greater depreciation would encounter objections from London's EC partners and intensify domestic inflation. Less depreciation would probably not give the United Kingdom sufficient competitive edge to maintain desired export expansion.

The improvement in Britain's official settlements balance has already begun, owing primarily to a turnaround in the capital account balance from a deficit of US \$500 million in the last quarter of 1972 to a surplus of more than \$600 million in the first quarter of 1973. Inflows of capital for the North Sea oil projects and movements of funds to London in response to higher interest rates prevailing there have been major factors strengthening the capital account.

At some \$2.7 billion, the estimated trade deficit in 1973 will be approximately \$1.0 billion larger than that in 1972, chiefly as a result of the pull exerted on imports by domestic economic expansion and the initial, adverse effects of the June 1972 sterling depreciation. In the second half of 1973, however, the influence of changed price relationships on trade volume will begin to be felt, expanding exports and slowing import growth. These effects, together with the tempering of import demand as domestic economic growth levels off, will reduce monthly trade deficits and leave the current account in approximate balance during late 1973.

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Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted]

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Britain's bilateral trade surplus with the United States probably will not change significantly in 1973. The rapid expansion of UK exports to the United States is roughly matched by the rise in British demand for US products, particularly machinery and equipment. At the same time, however, inflows of US capital - much of it related to US oil companies' investments in the North Sea - will improve Britain's bilateral capital balance with the United States.

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CONFIDENTIAL**DISCUSSION****From Devaluation to Revaluation**

1. From 1967 to 1971, Britain's balance of payments improved sharply. In the year that followed the 14.3% devaluation of sterling in November 1967, the payments balance worsened as the adverse price effects of devaluation deepened the trade deficit, encouraging short-term capital outflows. After 1968, however, the enhanced competitiveness of British goods began to stimulate foreign demand, and the balance of payments improved dramatically. In 1971 the official settlements balance reached a record \$8.2 billion surplus (see Table 1).

Table 1**United Kingdom: Balance-of-Payments Summary¹**

	Billion US \$					
	1967	1968	1969	1970	1971	1972
Current account						
balance	-0.9	-0.6	1.1	1.7	2.6	Negl.
Merchandise trade ²	-1.5	-1.6	-0.3	Negl.	0.8	-1.7
Services and transfers	0.7	0.9	1.4	1.6	1.8	1.8
Long-term capital movements	-0.3	-0.3	-0.3	-0.5	0.2	-2.1
Basic balance	-1.1	-1.0	0.8	1.1	2.8	-2.0
Short-term capital movements ³	-0.7	-2.4	1.0	2.0	5.1	-1.1
Allocation of SDRs	....	....	....	0.3 ⁴	0.3	0.3
Official settlements balance	-1.8	-3.4	1.8	3.4	8.2	-2.9
Change in official reserves	-0.3	-0.3	0.1	0.3	3.7	-1.7
Other official financing	-1.5	-3.1	1.7	3.1	4.4	-1.1

1. Because of rounding, components may not add to the totals shown. A more detailed balance of payments, with quarterly data for 1971-72, is presented in Appendix Table A-1.

2. F.o.b./f.o.b. basis.

3. Including changes in commercial banks' foreign position; also net errors and omissions.

4. Including small payments to IMF gold fund.

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2. The trade balance improved markedly from a \$1,500 million deficit in 1967 to an \$800 million surplus in 1971. The dollar value of exports grew by 52% during the period as volume rose by 35%. The sharp drop in export prices (in dollar terms) following the devaluation provided British exports with a competitive edge that lasted into 1971, when the rising trend in domestic costs overtook the gain from devaluation, again placing Britain in a weak competitive position. Import value increased by only 32% in 1968-71, as import volume and prices rose 23% and 7%, respectively. Stagnation of the domestic economy - real GNP rose an average of only 2.2% yearly in 1968-71 - played a major role in the slow import growth, although the higher costs of imports resulting from the sterling devaluation had some effect.

3. The usual invisibles surplus increased steadily after the devaluation and by 1971 was more than two and one-half times as large as in 1967. Nearly all of this increase occurred in the surplus on private services. Increased receipts from financial services such as insurance and securities brokerage provided by London banks and investment houses, in particular, fueled the rise.

4. The capital balance also gained strength after 1967. Long-term capital deficits gave way to a small surplus in 1971, when there was a sharp rise in foreign investment in Britain, partly related to incipient North Sea oil exploration. Short-term flows improved by \$5.8 billion from 1967 to 1971 as the trade account improved, speculation on a second devaluation of sterling declined, and higher London interest rates attracted short-term funds. Weakness in other currencies, particularly the US dollar in 1971, was also a major factor contributing to the large short-term inflows.

5. As the Smithsonian Agreement went into effect, Britain's payments was, superficially, quite good. The year's huge payments surplus had raised reserves to a record level (\$8.8 billion at the end of 1971). Underlying forces, however, augured a worsening trade balance. Large wage settlements were pushing up unit labor costs and contributing to accelerated inflation (see Figure 1). By this time, Britain had largely lost the competitive advantage realized from the 1967 devaluation. Rising labor problems were also impairing British competitiveness by reducing industry's ability to meet firm delivery dates. Moreover, the sluggishness of the domestic economy, largely responsible for the slow growth of imports since 1967, was giving way to fairly rapid domestic economic growth under the stimulus of expansionary budgets. Consequently, Britain entered the post-Smithsonian period with a rapidly weakening foreign sector, aggravated by the psychological effects of sterling's appreciation relative to the US dollar.

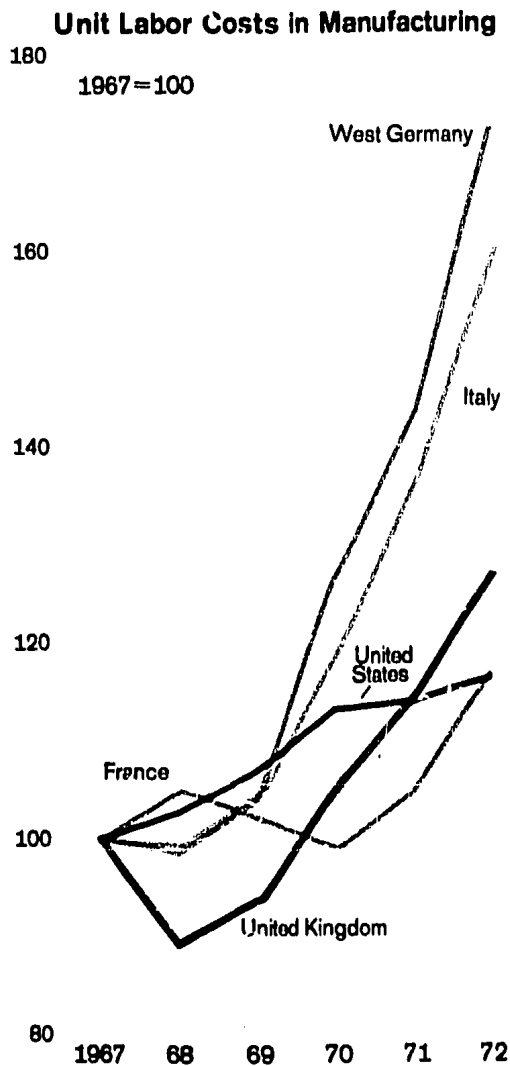
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Figure 1

Factors Affecting Export Performance

In Dollar Terms



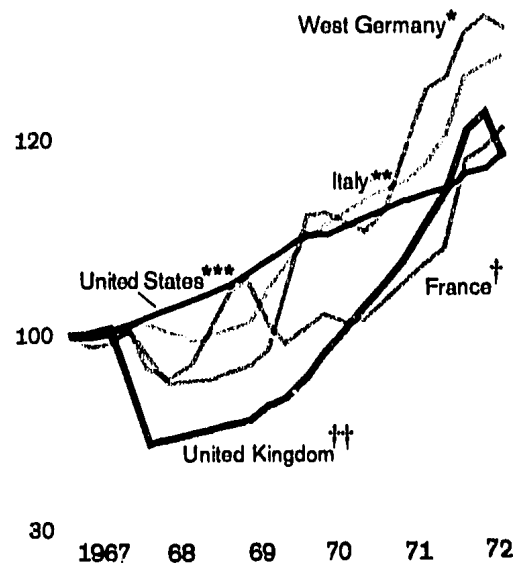
*Producer prices, intermediate goods.
 **Non-agricultural goods.
 ***Manufactured goods.
 †Intermediate goods.
 ††Manufactured goods, home market.

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Wholesale Prices

140

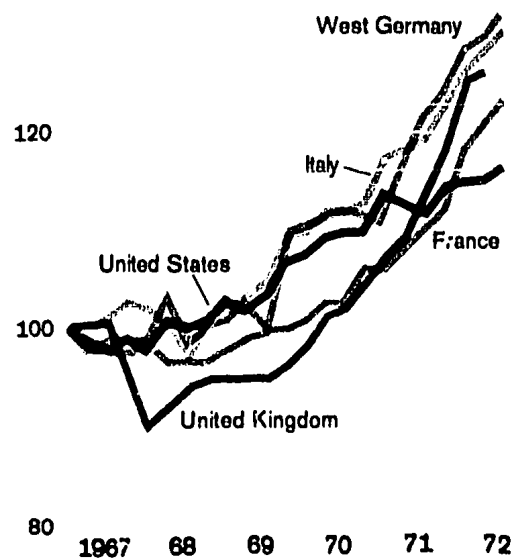
1st Qtr 1967=100



Export Prices

140

1st Qtr 1967=100



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CONFIDENTIAL**The Smithsonian Agreement and Developments in 1972**

6. Under the terms of the Smithsonian Agreement, sterling appreciated by 8.57% against the US dollar. Because other currencies appreciated more, however, the global, trade-weighted appreciation of sterling was held to about 1%. The percentage change in sterling's exchange rate relative to selected currencies was as follows:

	Percent
US dollar	8.6
Italian lira	1.0
French franc	No change
Belgian franc	-2.7
German mark	-4.4
Swiss franc	-4.7
Japanese yen	-7.1

7. The Smithsonian exchange rates appeared to be appropriate in the months immediately following the Agreement, and sterling traded slightly above its dollar central rate during March-May without Bank of England intervention (see Figure 2). In mid-June 1972, however, sterling suddenly weakened as a result of continuing rapid domestic inflation and five consecutive monthly trade deficits. From 19 to 23 June, a heavy speculative outflow of capital necessitated some \$2.5 billion in support operations by European central banks. Finally, on 23 June, London announced that the pound would be allowed to float. The dollar rate for sterling fell rapidly to about 7% under the Smithsonian central rate and then, recovering slightly, stabilized at about \$2.45. In the last quarter of 1972, sterling declined further, to about 10% below its Smithsonian central rate. Since most other major currencies were approximately maintaining their Smithsonian central rates with the dollar, the downward float resulted in a global depreciation of more than 10% from mid-June to the end of December 1972.

Current Account

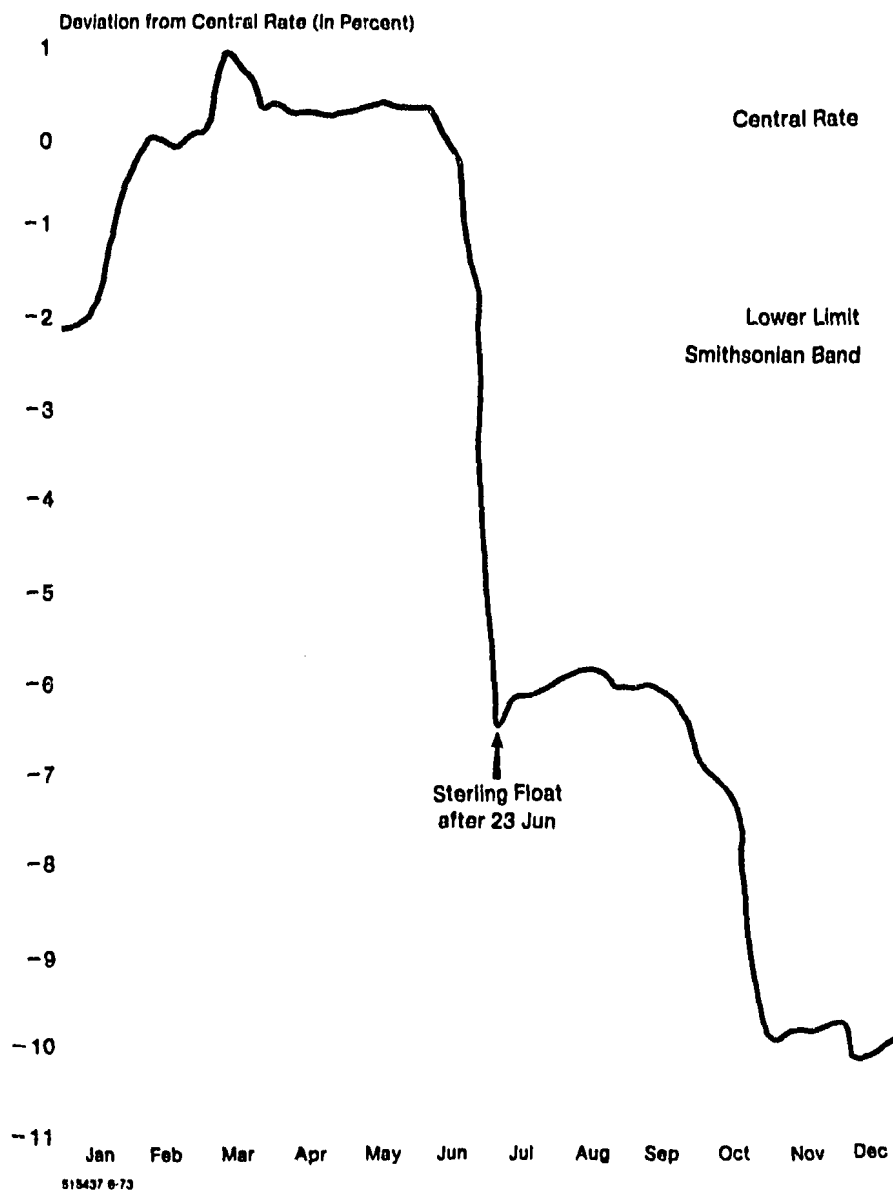
8. Although Britain's current account balance deteriorated sharply from 1971 to 1972, the small and brief appreciation of sterling was only a minor factor in the setback. The current account was in surplus in the first half of 1972, as strong invisible receipts offset the declining trade balance. After mid-year, however, the trade account decline steepened, and, as a result, the current account balance for the year showed a surplus of only \$45 million, compared with a record surplus of \$2.6 billion in 1971 (see Appendix Table A-1).

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Dollar-Sterling Exchange Rates in 1972

Figure 2

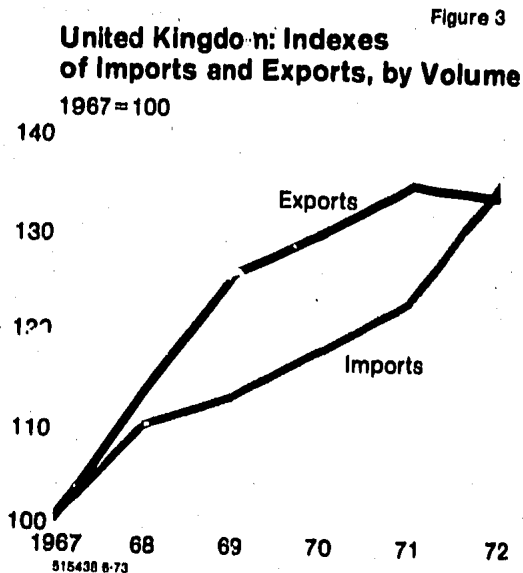


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9. The trade balance shifted from an \$800 million surplus in 1971 to a \$1.7 billion deficit in 1972 (see Appendix Table A-2). The drastic turnaround resulted from a 10% rise in import volume combined with a slight drop in export volume (see Figure 3). Movements in import and export prices, each up about 8% in dollar terms for the year as a whole, had little net effect on the trade balance. Altogether, the value of imports shot up 19% in dollar terms while exports increased only 7%.

10. Several factors contributed to the severely worsened trade balance in 1972. The resurgence of the domestic economy, growing at an annual rate of 3.5% in late 1972 - compared with an average of 2.2% in 1968-71 - strongly stimulated import demand, especially for manufactured goods. Export sales, in contrast, were depressed by prolonged coal and dock strikes, which disrupted the production and shipment of goods. Deterioration of the terms of trade, as import prices increased faster than export prices following the June float, contributed to the large deficit in the second half of the year.



11. Changes in Britain's trade balances with individual trading partners varied widely. The bilateral surplus with the United States - Britain's largest individual trading partner (see Figure 4) - increased from \$100 million in 1971 to \$320 million in 1972 as rapid US growth exerted a strong pull on UK exports. Lowered sterling costs of imports from the United States resulting from the dollar's depreciation relative to sterling also contributed to the increased surplus. The trade account with the EC of Six, however, moved from only a small deficit in 1971 to a \$750 million deficit in 1972, led by a \$400 million rise in the deficit with West Germany. An increase of 38% in UK imports of EC machinery and equipment was a major factor in the increased UK/EC deficit. The initial effects of the devaluation of sterling against most of the EC currencies also hurt Britain's trade balance.

12. At \$1.8 billion in 1972, the invisibles surplus was down slightly from 1971. The decline resulted chiefly from an increased deficit on government services and transfers. In addition there was a smaller surplus on interest, profits, and dividends because rising UK interest rates and increased

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profits led to growing payments abroad. The private services accounts continued to be strong, registering a surplus of more than \$2.1 billion -- some 8% above the 1971 figure.

Capital Flows

13. The capital account deteriorated sharply in 1972. Speculation against sterling prior to its float produced a massive short-term capital outflow in the second quarter (see Appendix Table A-3), resulting in a \$1.1 billion short-term capital deficit for the year. In the second half of 1972, high interest rates and decreased risk of further sterling depreciation resulted in net short-term inflows. The long-term capital balance weakened throughout the year, partly because of the currency uncertainties but mainly as a result of the chronic problems of inflation and labor stoppages, which continued to discourage foreign investment in Britain.

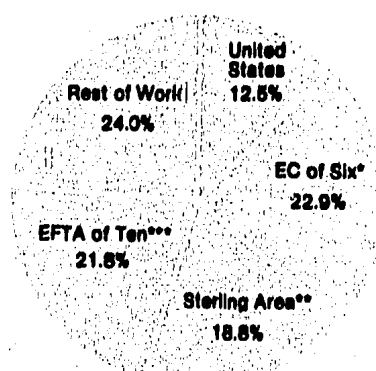
Outlook

14. Britain's balance of payments will remain in deficit in 1973. Indeed, deterioration in the trade account will result in the first annual current account deficit since 1968. The worsening of the current account balance will be checked in the second half of the year as domestic growth levels off and the effects on trade volume of sterling's 13% global depreciation since June 1972 begin to improve trade performance. Despite the expected current account deficit, more favorable capital flows should reduce the deficits in the basic balance and the official settlements balance.

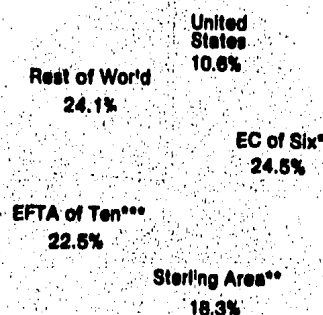
United Kingdom: Geographic Distribution of Foreign Trade, 1972

Figure 4

Exports



Imports



*Belgium, France, Italy, Luxembourg, Netherlands, and West Germany.

**Primarily countries with colonial ties to the United Kingdom; the main trading partners in this group are Australia, India, New Zealand, Nigeria, and South Africa.

***Austria, Denmark, Finland, Iceland, Ireland, Norway, Portugal, Sweden, Switzerland, and United Kingdom.

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CONFIDENTIAL**Current Account**

15. The trade deficit will increase to an estimated \$2.7 billion in 1973 (see Table 2). About 60% of the deficit is expected to occur in the first

Table 2

United Kingdom: Current Account Balances

Billion US \$					
	1972	Projected 1973	Half-Year Figures		
			1972 Jul-Dec	Projected 1973	
				Jan-Jun	Jul-Dec
Visible trade balance	-1.7	-2.7	-1.2	-1.7	-1.0
Exports	22.8	28.0	11.2	13.4	14.6
Imports	24.6	30.7	12.4	15.1	15.6
Invisible balance	1.8	1.7	0.9	0.8	0.9
Current account balance	Negl.	-1.0	-0.4	-0.9	-0.1

half of the year, with a \$900 million deficit already having been recorded in the first quarter. In Britain, import volume rises more strongly than GNP in an economic upswing: for example, since the end of 1971 import volume rose by 20% compared with a 9% rise for GNP. Continued expansion in 1973 will further boost import volume and, together with expected import price rises, add significantly to the import bill.

16. Britain's trade balance in 1973 will be damaged to a minor degree by sterling's depreciation since June 1972. (Despite the rise in the dollar/sterling rate to about \$2.58 since the February 1973 devaluation of the US dollar, sterling remains depreciated by about 13% on a trade-weighted basis.) The terms of trade were worsened by the depreciation, and trade volume thus far has not been as greatly affected. At some point after mid-year, however, the depreciation should begin to have a positive effect on the trade balance, particularly through accelerated export growth.

17. Because Britain must import much of its raw material needs, the sharp rise in world commodity prices over the past 12 months has also inflated the trade deficit. Increases in raw material supplies are expected to moderate the price rises for some commodities. If such relief does not occur, however, the trade deficit could exceed \$3.0 billion.

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18. A projected surplus of \$1.7 billion on services and transfers will offset much of the trade deficit. This surplus, however, will be slightly lower than its 1972 counterpart because of payments to the EC budget, higher interest payments on foreign-held securities, and increased sterling costs of invisible imports resulting from the sterling depreciation. Most of the decline in the invisibles surplus will occur in the first half of the year. During the second half, the upward trend in the invisibles surplus will resume as the demand for British services increases as a result of the lower foreign currency prices.

Capital Account

19. In contrast to the current account, the capital account's performance should improve markedly, a \$627 million surplus already having been recorded in the first quarter. In particular, long-term capital investments will be attracted by growth in the domestic economy, the apparent slackening of labor stoppages, and -- assuming stringent Phase III controls -- reduced wage inflation. Recent settlements of major labor negotiations within the government guidelines, particularly in the key coal industry, suggest an improvement in the investment climate in Britain. Another factor that will benefit the long-term capital balance in 1973 and for several subsequent years is the upsurge of investment in the North Sea oil projects. Although these investments are just beginning to be made on a large scale, they will account for nearly \$1.0 billion of long-term capital inflow in 1973. The cumulative inflow associated with these projects is expected to exceed \$10 billion during the next decade.

20. The short-term capital balance should also register some improvement over 1972. Following the pound's downward float, net short-term inflows occurred in the second half of 1972. This trend will be underpinned in 1973 by the high interest rates prevailing in Britain.

UK/US Bilateral Balance

21. Britain's payments balance with the United States will improve in 1973. Flows of long-term capital from the United States will move upward in the light of US investment in the North Sea, the revival in the UK domestic economy, and the UK's entry into the EC. Relatively higher UK interest rates will contribute to increasing the flow of short-term capital from the United States to Britain. Although some forms of British investment in the United States are increasing, primarily purchases of stock of US companies, the flow of UK capital to the United States probably will not expand as much as US capital exports to Britain.

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22. Britain's bilateral trade surplus with the United States probably will not change significantly in 1973. Exports to the United States have expanded sharply, but rising British imports of US products, especially machinery and equipment (the United States accounts for 20% of Britain's machinery and equipment imports), will roughly match these gains. The February 1973 currency realignments, which have resulted in an approximate 10% appreciation of sterling relative to the dollar since the end of 1972, will not strongly affect the bilateral trade surplus in 1973.

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APPENDIX

STATISTICAL TABLES

Table A-1

United Kingdom: Balance-of-Payment Trends

	Million US \$ ¹							
	Current Account Balance	Long-Term Capital Movements	Basic Balance	Short-Term Capital Movements ²	SDR Alloca- tions	Official Settlements Balance	Change in Official Reserves	Other Official Financing
Year								
1967	-867	-278	-1,145	-702	....	-1,847	-317	-1,530
1968	-650	-307	-957	-2,426	....	-3,383	-273	-3,110
1969	1,066	-252	814	970	....	1,784	106	1,678
1970	1,651	-547	1,104	1,985 ³	319 ⁴	3,408	300	3,108
1971	2,562	229	2,791	5,077 ³	305	8,173	3,744	4,429
1972	45	-2,093	-2,048	-1,115 ³	310	-2,853	-1,730	-1,123
Quarter ⁵								
1971								
1st	312	346	658	1,677	300	2,635	490	2,145
2nd	722	72	794	728	....	1,522	303	1,219
3rd	880	-3	877	756	....	1,633	1,408	225
4th	651	-198	453	1,934	....	2,387	1,578	809
1972								
1st	153	-347	-194	342	321	469	495	-26
2nd	299	-639	-340	-2,376	....	-2,716	-119	-2,597
3rd	-277	-389	-666	472	....	-194	-1,564	1,376
4th	-102	-705	-807	333	....	-469	-469	....
1973								
1st	-462	N.A.	N.A.	627 ⁶	N.A.	N.A.	N.A.	N.A.

1. Converted at average exchange rate for the period. Therefore, because of weighting implicit in average annual exchange rates, quarterly figures will not add to annual figures.

2. Including changes in commercial banks' foreign positions, net errors and omissions, and for quarterly figures, net seasonal adjustment on current account.

3. Adjusted for exchange valuation discrepancy on SDR allocations.

4. Including a payment to I.M.F. gold fund subscription.

5. Current account balances have been seasonally adjusted.

6. Including long-term balance.

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Table A-2

United Kingdom: Current Account Trends

Million US \$¹

	Current Account Balance	Merchandise Trade			Services and Transfers					
		Net Balance	Exports f.o.b.	Imports f.o.b.	Net Balance	Government Services	Private Services	Interest, Profits, Dividends	Government Transfers	Private Transfers
Year										
1967	-867	-1,533	14,106	15,639	666	-757	1,019	1,043	-518	-121
1968	-650	-1,555	15,058	16,613	905	-689	1,351	804	-430	-132
1969	1,066	-343	16,951	17,294	1,409	-696	1,455	1,193	-425	-118
1970	1,651	29	18,943	18,914	1,622	-754	1,685	1,186	-413	-82
1971	2,562	773	21,439	20,666	1,789	-804	1,974	1,141	-488	-34
1972	45	-1,730	22,844	24,574	1,775	-898	2,126	1,092	-520	-25
Quarter (Seasonally adjusted)										
1971										
1st	312	-149	4,781	4,930	461	-184	434	314	-103	---
2nd	722	283	5,438	5,155	439	-190	449	302	-112	-10
3rd	880	442	5,592	5,150	438	-220	524	276	-132	-10
4th	651	200	5,637	5,437	451	-210	570	246	-140	-15
1972										
1st	153	-316	5,658	5,974	469	-220	552	282	-137	-8
2nd	299	-138	5,994	6,132	437	-218	525	270	-132	-8
3rd	-277	-695	5,038	5,733	418	-230	521	254	-122	-5
4th	-102	-551	6,119	6,670	449	-227	525	284	-128	-5
1973										
1st	-462	-882	6,440	7,322	420	N.A.	N.A.	N.A.	N.A.	N.A.

1. Converted at average exchange rate for the period. Therefore, because of weighting implicit in average annual exchange rates, quarterly figures will not add to the annual figures.

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Table A-3
United Kingdom: Capital Flow Trends

	Million US \$ ¹									
	Long-Term				Short-Term					
	Long-Term Balance	Official Long-Term	Overseas Investment in the UK	UK Investment Overseas	Short-Term Balance ²	Foreign Currency Borrowing	Exchange Reserves in Sterling	Other Sterling Liabilities	Net Trade Credit	Unidentified
Year										
1967	-278	-162	1,140	-1,256	-702	33	-518	-264	-509	556
1968	-307	38	1,399	-1,744	-2,426	74	-432	-307	-607	-1,154
1969	-252	-237	1,615	-1,630	970	-86	754	-128	-386	816
1970	-547	-489	1,752	-1,810	1,985	1,150	463	638	-489	223
1971	229	-666	2,708	-1,813	5,077	1,207	1,738	1,723	-636	1,045
1972	-2,093	-608	1,891	-3,376	-1,115	1,193	775	-220	-185	-2,678
Quarter										
1971										
1st	346	-108	994	-546	1,824	216	540	144	-120	1,044
2nd	72	-105	686	-509	612	372	672	-12	-300	-120
3rd	-3	-86	479	-396	775	76	237	588	105	-251
4th	-198	-373	539	-364	1,882	529	278	1,030	-323	368
1972										
1st	-347	-109	563	-801	596	293	524	8	35	-264
2nd	-639	-101	330	-868	-2,525	-343	92	-437	-140	-1,697
3rd	-389	-42	509	-856	531	448	-223	-7	---	313
4th	-705	-343	483	-845	187	740	388	189	-80	-1,050
1973										
1st	N.A.	N.A.	N.A.	N.A.	627 ³	N.A.	N.A.	N.A.	N.A.	N.A.

1. Converted at average exchange rate for the period. Therefore, because of weighting implicit in average annual exchange rates, quarterly figures will not add to the annual figures.

2. Including errors and omissions (unidentified), but excluding net seasonal adjustments to current account in quarterly data.

3. Including long-term balance.